[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-116733-98]

RIN 1545-AW79

Guidance under section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These proposed regulations affect corporations and are necessary to provide them with guidance needed to comply with these changes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 5, 2000. Outlines of topics to be discussed at the public hearing scheduled for January 26, 2000, at 10 a.m. must be received by January 5, 2000.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-116733-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-116733-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Brendan O'Hara, (202) 622-7530; concerning submissions of comments, delivering comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. <u>State of the Law Before Section 355(e)</u>

Section 355 generally provides that, if a corporation distributes to its shareholders stock of a corporation which it controls immediately before the distribution and certain other conditions are met, neither the distributing corporation nor its shareholders recognize gain or loss. A number of the conditions for tax free treatment (for example, the continuity of interest requirement of §1.355-2(c), the "no device" requirement of section 355(a)(1)(B), the five-year active business requirement of section 355(b), and the limitation on disqualified stock under section 355(d)) operate to limit the circumstances in which the distributing or controlled corporation can undergo changes of control in conjunction with a distribution that qualifies for corporate and shareholder-level nonrecognition under section 355. Nevertheless, prior to the enactment of section 355(e), it was possible for such changes to occur, for example, in the context of tax free reorganizations, while qualifying for tax free treatment under section 355. See, e.g., Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

B. Legislative Proposals Leading to Section 355(e)

As part of its Fiscal Year 1997 Budget, the Administration proposed a provision that would require a distributing corporation to recognize gain on the distribution of a controlled corporation's stock unless the direct and indirect shareholders of the distributing corporation, as a group, controlled at least 50 percent of the vote and value of both corporations at all times during the 4-year period beginning 2 years before the distribution. See Department of the Treasury, General Explanation of the Administration's Revenue Proposals, p. 86 (March 1996) (hereinafter referred to as the "Administration Proposal"). Under the Administration Proposal, the retained 50-percent interest must consist of "permissible stock," which includes, in addition to stock retained over the 4-year period, stock of the distributing or controlled corporation "received by the shareholder in a transaction which is unrelated to the distribution . . . ." Revenue Proposals Contained in President Clinton's Budget Plan as Released on Mar. 19, 1996, §9522, [1996] 83 Stand. Fed. Tax Rep. (CCH) No. 15A.

The Administration Proposal described an unrelated transaction as, "[a] transaction that is not pursuant to a common plan or arrangement that includes the distribution," and cited a hostile acquisition of the distributing or controlled corporation commencing after the distribution as an example of an unrelated transaction. The Administration

Proposal contrasted this with a friendly acquisition, which generally would be considered related to the distribution if the acquisition was pursuant to an arrangement negotiated prior to the distribution, even if the acquisition was subject to various conditions at the time of the distribution.

On April 17, 1997, House Ways and Means Committee Chairman Archer and Senate Finance Committee Chairman Roth and Ranking Member Moynihan introduced identical bills (H.R. 1365, 105th Cong. (1997) and S. 612, 105th Cong. (1997), hereinafter referred to as the "Bills") that provided for a new section 355(e) that is similar to the enacted version. The Bills were concerned with a "plan (or series of related transactions) pursuant to which a person acquires stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation . . . ." S. 612, 105th Cong. (1997). The introductory statement to the legislation contained a reference to acquisitions "pursuant to a plan or arrangement in existence on the date of distribution . . . ." The statement further explained: "Whether a corporation is acquired would be determined under rules similar to those of present-law section 355(d), except that acquisitions would not be restricted to purchase transactions. Thus an acquisition would occur if a person-or persons acting in concert-. . . acquired . . . stock . . . pursuant to a plan or arrangement." <u>See</u> 143 Cong. Rec. E703 (Apr. 17, 1997) (introductory statement of Chairman Archer); 143 Cong. Rec. S3360 (Apr. 17, 1997) (introductory statement of Chairman Roth).

C. <u>Enactment of Section 355(e)</u>

Section 355(e) was enacted in 1997. Public Law 105-34, section 1012(a) (1997). The committee reports state that section 355 was intended to permit the tax free division of existing business arrangements among existing shareholders. The reports state that "[i]n cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired" and provide that gain is recognized "if, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired . . . ." H.R. Rep. No. 105-148, at 462 (1997); see also S. Rep. No. 105-33, at 139-40 (1997) (slight variation in language). The Conference Report adds, "[a]s under the House bill and Senate amendment, a public offering of sufficient size can result in an acquisition that causes gain recognition under the provision." H.R. Conf. Rep. No. 105-220, at 533 (1997).

The statute as enacted contained two important changes from the Administration Proposal and Bills relevant to determining whether an acquisition is part of a plan (or series of related transactions) that includes the distribution. In the Bills, proposed sections 355(e)(2)(A)(ii) and (4)(C)(i) provided that a "person," as modified by section 355(d)(7), must acquire 50 percent or more of the distributing or controlled corporation. The term "plan or arrangement" used in section 355(d)(7)(B) treats two or more persons acting "pursuant to a plan or arrangement" with regard to a stock acquisition as one person. However, when section 355(e) was enacted, the reference in section 355(e)(2)(A)(ii) to acquisitions by a "person" was changed to "1 or more persons." In addition, the reference to section 355(d)(7)(B) (treating two or more persons acting "pursuant to a plan or arrangement" as one person) was deleted from section 355(e)(4)(C)(i). The effect of these two changes is to remove the requirement that 50 percent or more of the stock of the distributing or controlled corporation must be acquired by acquirors acting in concert for section 355(e) to apply.

In addition, the reference in the Conference Report to public offerings as transactions that could cause gain to be recognized under section 355(e) indicates Congress did not believe negotiations between the distributing corporation and an acquiror were necessary in order for an acquisition to be pursuant to a plan that included the distribution. Thus, to determine whether a plan of acquisition exists, one must look at all parties to the transaction, including the distributing and controlled corporations and their shareholders, not just the potential acquirors.

As enacted, section 355(e)(1) provides that the stock of a controlled corporation will not be qualified property under section 355(c)(2) or section 361(c)(2) if, under section 355(e)(2)(A), the stock is distributed as "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation." Thus, if section 355(e)(1) applies to a distribution, the distributing corporation is taxed on the amount by which the distributed stock's fair market value exceeds its basis. Distributee shareholders receive the controlled corporation stock tax free, but do not increase their bases to reflect the corporate level gain recognized by the distributing corporation on the distribution.

Explanation of Provisions

The proposed regulations under section 355(e) provide guidance concerning the interpretation of the phrase “plan (or series of related transactions).” The proposed regulations also address the determination of the distributing corporation’s gain when multiple controlled corporations are distributed and the distributions are part of a plan (or series of related transactions) pursuant to which a 50-percent or greater interest in one or more, but not all, of the distributed controlled corporations is acquired. The Department of the Treasury and the IRS plan to issue regulations addressing other issues arising under section 355(e), including aggregation and attribution rules (including provisions for public trading) and the administration of the statute of limitations provision of section 355(e)(4)(E). Comments concerning the proposed regulations and additional issues that should be addressed in regulations are welcome.

A. Plan or Series of Related Transactions

Whether two transactions are part of the same “plan (or series of related transactions)” under section 355(e)(2)(A) is a subjective test, depending ultimately on the intentions and expectations of the relevant parties. As discussed above, indications are that Congress intended “plan (or series of related transactions)” to be interpreted broadly. Unlike the Administration Proposal and the Bills, which utilized the section 355(d) concept of “a person” (with aggregation) as the reference for relevant acquirors, the statute, as enacted, expanded the universe of transactions to which section 355(e) potentially applies by providing that the relevant acquirors could be “1 or more persons.” Also, the guidance in the Conference Report that public offerings of a sufficient size could trigger section 355(e) suggests that there does not necessarily have to be an identified acquiror on the date of the distribution for section 355(e) to apply, nor is the intent of the acquiror at the time of the distribution necessarily relevant in determining whether there is a plan.

The proposed regulations rely on a variety of factors to determine the existence of a plan (or series of related transactions) (hereinafter referred to as a “plan”). These factors include the business purpose or purposes for the distribution; the intentions of the parties; the existence of agreements, understandings, arrangements, or substantial negotiations; the timing of the transactions; the likelihood of an acquisition; and the causal connection between the distribution and the acquisition.

Congress specified one factor, temporal proximity, as affecting the determination of whether a plan exists. Specifically, section 355(e)(2)(B) provides a presumption that a plan exists if "1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution." Accordingly, the proposed regulations provide that distributions within 2 years of an acquisition of the distributing corporation or a controlled corporation are presumed to be part of a plan. The proposed regulations outline the elements the distributing corporation must establish to rebut the statutory presumption.

1. Acquisitions on or After a Distribution

General rebuttal

In the case of an acquisition occurring within 2 years after a distribution, the proposed regulations allow the distributing corporation to rebut the presumption by establishing by clear and convincing evidence that (i) the distribution was motivated in whole or substantial part by a corporate business purpose (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired) and (ii) the acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter. Decreasing “the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired” generally refers to transactions in which one business, a perceived takeover target, is separated from another via a stock distribution in an attempt to spare the other business from acquisition. Distributions intended to “decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired” are often difficult to differentiate from those intended to “facilitate an acquisition.” Both relate to a perceived possibility of acquisition and should receive similar treatment.

In this general rebuttal, the proposed regulations rely on corporate business purpose as a key factor indicating whether a distribution and an acquisition are part of a plan. Corporate business purpose is an important concept in the overall administration of section 355. The existence of a nonacquisition related corporate business purpose that prompted, in whole or substantial part, the distributing corporation to make the stock distribution suggests there is not a significant causal connection between the distribution and acquisition. The intent of the distributing corporation, the controlled corporation, or the controlling shareholders of either the distributing or controlled corporation to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired is relevant in determining the extent to which the distribution was motivated in whole or substantial part by another corporate business purpose within the meaning of §1.355-2. Analyzing whether there is another substantial corporate business purpose for the distribution in light of an acquisition-related purpose is similar to analyzing whether there is a corporate business purpose for a distribution in light of the potential avoidance of federal taxes. See §1.355-2(b)(1) and (5), Example 8. Thus, another business purpose must be real and substantial even in light of the acquisition business purpose.

The reliance on business purpose in the general rebuttal is consistent with the suggestions of many commentators writing about section 355(e), who identified corporate business purpose as an important factor in determining whether an acquisition and distribution are part of a plan.

Alternative rebuttal

Reliance on a substantial nonacquisition business purpose as proof of no “plan” is appropriate when the distribution and acquisition are separated by a sufficient amount of time. Thus, the general rebuttal is not satisfied in certain cases, including where an acquisition occurs within 6 months after a distribution or where a distribution was not substantially motivated by a corporate business purpose other than an intention to facilitate (or decrease the likelihood of) an acquisition. These acquisitions occur in circumstances more likely to indicate the existence of a plan at the time of the distribution. Thus, these acquisitions are subject to heightened scrutiny and will be considered part of a plan unless taxpayers satisfy a more stringent alternative rebuttal.

Unlike the general rebuttal, a nonacquisition business purpose alone is not sufficient under the alternative rebuttal. Rather, taxpayers must satisfy all prongs of a three-prong test.

The first prong of the alternative rebuttal may be satisfied in either of two ways. The distributing corporation must establish by clear and convincing evidence either that (i) at the time of the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest in the distributing or any controlled corporation during the statutory presumption period (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) or (ii) the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation. Clause (i) may be satisfied even in situations where one or more of the relevant parties intend that the distribution will facilitate an acquisition or acquisitions, so long as the parties do not intend that there be a 50-percent or greater change in ownership during the statutory presumption period. Alternatively, clause (ii) may be satisfied where the parties intend a 50-percent or greater change in ownership during the presumption period, provided that the parties do not intend that the distribution will facilitate any part of the acquisitions.

Under the second prong of the alternative rebuttal, the distributing corporation must establish by clear and convincing evidence that, at the time of the distribution, neither the distributing corporation, the controlled corporation, nor their controlling shareholders reasonably would have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in the distributing corporation or the controlled corporation within 2 years after the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests if the distribution had not occurred.

This prong of the alternative rebuttal (hereinafter referred to as the “reasonable anticipation” test) incorporates two important concepts. First, it identifies reasonably anticipated acquisitions of the distributing or controlled corporation that would not have occurred but for the distribution and, because a causal connection exists between the two transactions, treats them as part of a plan. Second, it reflects the idea that reasonable anticipation, not just the presence of negotiations, is important in determining whether a plan exists. Considering reasonable anticipation of certain acquisitions is consistent with the legislative history. Though descriptions of the Administration Proposal included references to negotiations and distinctions between hostile and friendly acquisitions, the focus of section 355(e), as enacted, is whether a relationship exists between the distribution and the fact that persons other than the existing shareholders became owners of the distributing or controlled corporation.

A reasonable anticipation standard is necessary to implement section 355(e). Otherwise, a distributing corporation could attempt to avoid section 355(e) by distributing a controlled corporation under circumstances that virtually assure an acquisition of the distributing or controlled corporation, but arguing that, despite the imminence of the acquisition, effectuating the acquisition was not a motive for the distribution. A part of planning any transaction includes attempting to foresee actions others might take in response. Consistent with this business practice, it is appropriate, especially for acquisitions subject to heightened scrutiny, to require the distributing corporation to take into account the reasonably anticipated, likely actions of others to demonstrate that a distribution and acquisition are not part of a plan.

The second prong of the alternative rebuttal is not satisfied if, at the time of the distribution, the relevant parties would reasonably anticipate that the distribution would give rise to <u>all of</u> an acquisition of a 50 percent interest in the distributing or controlled corporation. (The rebuttal is satisfied if the distributing corporation establishes by clear and convincing evidence that the relevant parties would not reasonably anticipate an acquisition of a 50 percent or greater interest <u>by persons who would not acquire such interests absent the distribution</u>.) This standard is to be contrasted with the first prong of the rebuttal, which is not satisfied if one or more of the relevant parties intended that there be a 50 percent or greater acquisition of distributing or controlled during the applicable time period, and the distribution is intended to facilitate <u>all or any part of</u> that acquisition. Because some acquisitions might be reasonably anticipated to occur without regard to whether the distribution takes place, the Department of the Treasury and the IRS believe that the distribution must be directly linked to all 50 percent of the acquisition to fail the “reasonable anticipation” test. However, a different result is called for where the relevant parties <u>intend</u> a 50 percent acquisition. In that case, it would appear that the aggregation of the various acquisitions comprising the 50 percent acquisition are themselves part of a single plan, so a distribution intended to facilitate only some of those acquisitions would be part of a plan also involving those other acquisitions not directly facilitated by the acquisition.

In developing the reasonable anticipation test, the Department of the Treasury and the IRS rejected suggestions by some commentators that serious negotiations or agreement with an acquiror need to have taken place at the time of distribution for a plan to exist. Requiring mutual agreement or negotiation is inappropriate because Congress intended the statute to apply in situations beyond those in which a distribution is made prior to and as part of an acquisition by a specifically identified acquiror. Section 355(e)(2)(B) makes clear that the section is intended to apply to acquisitions before and after a distribution. The legislative history also clarifies that a public offering after a distribution can trigger section 355(e) even though presumably no public buyer would have been negotiated with or even identified at the time of the distribution. Because Congress intended distributions designed to facilitate public offerings to be covered, other transactions that are economically similar also should be covered. These transactions include a private placement of the distributing or controlled corporation's stock or an auction of such stock by an investment banker. Like public offerings, these transactions do not necessarily involve predistribution negotiations or agreements regarding subsequent acquisitions and yet may still be part of the distributing or controlled corporation's plan.

Thus, we believe that section 355(e) was intended to apply to a range of transactions, not limited to those in which a mutual agreement or negotiations relating to the acquisition occurred prior to the distribution. To require negotiations or agreements to be present prior to a distribution either would inappropriately exclude certain transactions from the coverage of the statute or would create a higher threshold for the existence of a plan in certain acquisitions than in other acquisitions.

The third prong of the alternative rebuttal reiterates a requirement in the general rebuttal. The distributing corporation must establish by clear and convincing evidence that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

For purposes of applying the alternative rebuttal, the consequences of the application of section 355(e), directly or by indemnity, are disregarded in determining the intentions, motivations, and reasonable anticipations of the relevant parties. To do otherwise might give rise to a circularity in the application of the rules. If the consequences of the application of section 355(e) were relevant in determining such intentions, motivations, and reasonable anticipations, the distributing corporation could argue that objective evidence indicated that it would satisfy the alternative rebuttal, since arguably it would not be reasonable for an acquiror to act in a manner that would cause liability for tax under section 355(e). Conversely, the IRS could argue that the presence of an indemnity agreement indicated that the parties anticipated liability for tax under section 355(e).

Acquisitions more than 2 years after a distribution

To prevent taxpayers from attempting to avoid the presumption period by delaying a planned acquisition beyond 2 years from the date of distribution, the proposed regulations provide that an acquisition occurring more than 2 years after the distribution is presumed part of a plan if there was an agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter. The distributing corporation may rebut the presumption using the general or alternative rebuttal discussed above. To provide certainty for transactions that, because of their separation in time, are unlikely to be part of a plan, the proposed regulations provide that, if there was no agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter, a distribution and an acquisition occurring more than 2 years afterwards are not part of a plan.

2. Acquisitions Before a Distribution

Acquisitions within 2 years before a distribution

Section 355(e) also applies to transactions in which an acquisition of the distributing or controlled corporation’s stock precedes a distribution of the controlled corporation. When the transactions being tested as part of a plan occur in this order, the most reliable indicators that a plan exists are an intent to make the distribution at the time of the acquisition and a causal connection between the acquisition and the distribution. In particular, if a person becomes a controlling shareholder by acquisition, that person's intention becomes the single best indicator of whether a later distribution was part of a plan. The proposed regulations allow a distributing corporation to rebut the presumption by establishing by clear and convincing evidence that, at the time of the acquisition, the distributing corporation and its controlling shareholders (determined immediately after the acquisition) did not intend to effectuate a distribution. Alternatively, the distributing corporation can rebut the presumption by establishing by clear and convincing evidence that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance), unless a person acquiring an interest becomes a controlling shareholder by reason of the acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter).

Acquisitions more than 2 years before a distribution

If an acquisition of an interest in the distributing corporation or the controlled corporation occurs more than 2 years before a distribution, the presumption shifts in favor of the taxpayer. The acquisition and the distribution are presumed not to be part of a plan unless the Commissioner can establish by clear and convincing evidence that, at the time of the acquisition, (i) the distributing corporation or its controlling shareholders intended to effectuate the distribution and (ii) that the distribution would not have occurred at approximately the same time and under substantially the same terms regardless of that acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance) or that a person acquiring an interest in that acquisition becomes a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within six months thereafter). Because the passage of time makes it less likely that an acquisition and distribution are part of a plan, after two years the proposed regulations shift the burden of proof to the IRS to prove the existence of a plan. However, the proposed regulations do not allow a taxpayer to avoid section 355(e) by delaying the distribution when the distribution clearly was intended at the time of the acquisition.

3. Agreement, Understanding, Arrangement, or Substantial Negotiations

The proposed regulations do not define with precision the terms <u>agreement, understanding, arrangement, or substantial negotiations</u>. A binding contract is clearly included as an agreement, but, depending on all relevant facts and circumstances, parties can have an agreement, understanding, or arrangement even though they have not reached agreement on all terms. Under certain circumstances, such as in public offerings or auctions of the distributing or controlled corporation's stock by an investment banker, an agreement, understanding, arrangement, or substantial negotiations can take place regarding an acquisition even if the acquiror has not been specifically identified. The Department of the Treasury and the IRS are particularly interested in receiving comments regarding transactions that involve an investment banker and when contacts by the distributing corporation or the controlled corporation with an investment banker or contacts with potential acquirors by an investment banker on behalf of the distributing corporation or the controlled corporation should or should not be considered an agreement, understanding, arrangement, or substantial negotiations.

4. Options

The proposed regulations also treat certain options as agreements. If stock of the distributing or controlled corporation is acquired pursuant to an option, the option is treated as an agreement unless the distributing corporation establishes by clear and convincing evidence that, on the later of the date of distribution or issuance, the option was not more likely than not to be exercised. Generally, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements, restricted stock, and any other instruments that provide for the right or possibility to issue, redeem, or transfer stock, cash settlement options, and other similar interests are treated as options. An option on an option is treated as an option under the proposed regulations. If there is an agreement, understanding, or arrangement to issue an option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement. If an agreement, understanding, or arrangement to issue an option is reached, or an option is issued, more than 6 months but not more than 2 years after the distribution, and there were substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued 6 months after the distribution. If there is an agreement, understanding, or an arrangement to issue an option more than 6 months but not more than 2 years after the distribution, and there were no substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement. The proposed regulations exempt certain options from treatment as options unless they are issued, transferred, or listed with a principal purpose of avoiding the application of section 355(e) or the proposed regulations. The enumerated exceptions cover certain commercially customary options unlikely to be used to avoid section 355(e) or the proposed regulations.

5. Aggregating Acquisitions That are Pursuant to a Plan

Under the proposed regulations, each acquisition of stock of a distributing or controlled corporation must be tested to determine whether the acquisition is pursuant to a plan involving a distribution. Each acquisition of stock of a corporation acquired pursuant to a plan involving a distribution is aggregated with all acquisitions of stock of that corporation acquired pursuant to a plan involving that distribution to determine whether an acquisition of a 50-percent or greater interest as proscribed in section 355(e)(2)(A)(ii) has occurred.

B. Any Controlled Corporation

Section 355(e)(2)(A)(ii) provides that section 355(e)(1), which causes the distributing corporation to recognize its gain in the controlled corporation stock as if the distributing corporation had sold the stock for its fair market value, applies to any distribution to which section 355 applies and "which is part of a plan . . . pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation" (emphasis added). A question has arisen concerning the measure of gain to the distributing corporation if, pursuant to a plan, the stock of more than one controlled corporation is distributed and stock representing a 50-percent or greater interest is acquired in some, but not all, of the distributed controlled corporations. The proposed regulations clarify that under those circumstances, the distributing corporation only recognizes gain on the stock of the distributed controlled corporations that were subject to 50-percent or greater acquisitions. If the distributing corporation is the acquired corporation, it must recognize gain on all of the distributed controlled corporations.

Proposed Effective Date

The regulations in this section are proposed to apply to distributions occurring after the regulations in this section are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted timely to the IRS. The IRS and the Department of the Treasury specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 26, 2000, beginning at 10 a.m. in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by January 5, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Brendan O'Hara, Office of the Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.355-7 also issued under 26 U.S.C. 355(e)(5). * * *

Par. 2. Section 1.355-0 is amended by revising the section heading and adding introductory text and an entry for §1.355-7 to read in part as follows:

§1.355-0 Outline of sections.

In order to facilitate the use of §§1.355-1 through 1.355-7, this section lists the major paragraphs in those sections as follows:

* * * * *

§1.355-7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) Plan or series of related transactions.
(1) In general.
(2) Distributions within 2 years of an acquisition.
(i) Presumption.
(ii) Rebuttal for acquisitions after a distribution.
(iii) Alternative rebuttal for acquisitions on or after a distribution.
(iv) Operating rules for paragraph (a)(2)(iii) of this section.
(v) Rebuttals for acquisitions before a distribution.
(A) General rebuttal.
(B) Alternative rebuttal.
(3) Distributions more than 2 years from an acquisition.
(i) Acquisitions after a distribution.
(ii) Acquisitions before a distribution.
(4) Controlling shareholder.
(5) Agreement, understanding, or arrangement.
(6) Multiple acquisitions.
(7) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests.
(i) Treatment of options.
(A) General rule.
(B) Agreement, understanding, arrangement, or substantial negotiations to issue an option.
(ii) Instruments treated as options.
(iii) Instruments generally not treated as options.
(A) Escrow, pledge, or other security agreements.
(B) Compensatory options.

Par. 3. Section 1.355-7 is added to read as follows:

§1.355-7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition--(a) Plan or series of related transactions-- (1) In general. (i) Except as provided in section 355(e) and in this section, section 355(e) applies to any distribution–

(A) To which section 355 (or so much of section 356 as relates to section 355) applies; and

(B) Which is part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

(ii) For purposes of this section, a controlled corporation is a corporation the stock of which is distributed in a distribution to which section 355 applies.

(iii) The existence of a plan (or series of related transactions) does not depend on whether or not more than one person acts in concert.

(2) Distributions within 2 years of an acquisition--(i) Presumption. If a distribution occurs within 2 years of an acquisition by one or more persons of an interest in the

distributing corporation or any controlled corporation, the distribution and that acquisition are presumed to be part of a plan (or series of related transactions).

(ii) Rebuttal for acquisitions after a distribution. (A) In the case of an acquisition occurring after a distribution, the distributing corporation may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that–

(1) The distribution was motivated in whole or substantial part by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired); and

(2) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter.

(B) The intent of the distributing corporation, the controlled corporation, or the controlling shareholders of either the distributing or controlled corporation to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired is relevant in determining the extent to which the distribution was motivated by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired).

(iii) Alternative rebuttal for acquisitions on or after a distribution. In the case of an acquisition occurring on or after a distribution, the distributing corporation also may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that–

(A)(1) At the time of the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest in the distributing or any controlled corporation during the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter); or

(2) The distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation; and

(B) At the time of the distribution, neither the distributing corporation, the controlled corporation, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in the distributing corporation or the controlled corporation within 2 years after the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests if the distribution had not occurred; and

(C) The distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

(iv) Operating rules for paragraph (a)(2)(iii) of this section. (A) For purposes of paragraph (a)(2)(iii)(A)(1) of this section, if an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation before the distribution is part of a plan (or series of related transactions) involving the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders must include the amount of stock acquired in that acquisition as an amount they intended at the time of the distribution to be acquired during the 2-year period beginning on the date of the distribution.

(B) For purposes of paragraph (a)(2)(iii)(B) of this section, persons who more likely than not would have acquired interests in the distributing corporation if the distribution had not occurred are also treated as persons who more likely than not would have acquired proportionate interests in the controlled corporation if the distribution had not occurred. No other persons are treated as persons who would have acquired interests in the controlled corporation if the distribution had not occurred.

(C) For purposes of paragraph (a)(2)(iii)(B) of this section, if an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation before the distribution is part of a plan (or series of related transactions) involving the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders must treat the amount of stock acquired in that acquisition as an amount they would reasonably have anticipated was more likely than not to be acquired within 2 years after the distribution that would not have been acquired if the distribution had not occurred.

(D) For purposes of determining the intentions, motivations, and reasonable anticipations of the relevant parties under paragraph (a)(2)(iii) of this section, the consequences of the application of section 355(e), directly or by indemnity, are disregarded.

(v) <u>Rebuttals for acquisitions before a distribution</u>–(A) <u>General rebuttal</u>. In the case of an acquisition occurring before a distribution, the distributing corporation may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that, at the time of the acquisition, the distributing corporation and its controlling shareholders (determined immediately after the acquisition) did not intend to effectuate a distribution.

(B) <u>Alternative rebuttal</u>. In the case of an acquisition occurring before a distribution, the distributing corporation may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of that acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance), provided no person acquiring an interest in that acquisition becomes a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter).

(3) <u>Distributions more than 2 years from an acquisition</u>--(i) <u>Acquisitions after a distribution</u>. (A) If an acquisition by one or more persons of an interest in the

distributing corporation or any controlled corporation occurs more than 2 years after a distribution, the distribution and that acquisition are presumed part of a plan (or series of related transactions) only if there was an agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter. The distributing corporation may rebut the presumption under paragraph (a)(2)(ii) or (a)(2)(iii) of this section.

(B) If an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation occurs more than 2 years after a distribution, and there was no agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter, the acquisition and the distribution are not part of a plan (or series of related transactions).

(ii) Acquisitions before a distribution. If an acquisition by one or more persons of an interest in the distributing corporation or the controlled corporation occurs more than 2 years before a distribution, the acquisition and the distribution are not part of a plan (or series of related transactions) unless the Commissioner can establish by clear and convincing evidence that--

(A) At the time of the acquisition, the distributing corporation or its controlling shareholders (determined immediately after the acquisition) intended to effectuate the distribution; and

(B)(1) The distribution would not have occurred at approximately the same time and under substantially the same terms regardless of that acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance); or

(2) A person acquiring an interest in that acquisition becomes a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter).

(4) Controlling shareholder. For purposes of paragraphs (a)(2) and (3) of this section, a controlling shareholder is any person who, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)), possesses voting power in the distributing or controlled corporation representing a meaningful voice in the governance of the corporation. A controlling shareholder of a publicly traded corporation is any person who, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)), owns 5 percent or more of any class of stock of the distributing or controlled corporation and who actively participates in the management or operation of the corporation. If a distribution precedes an acquisition, the controlled corporation's controlling shareholders immediately after the distribution are considered the controlled corporation's controlling shareholders at the time of the distribution.

(5) Agreement, understanding, or arrangement. For purposes of this section, the parties do not necessarily have to have entered into a binding contract or have reached agreement on all terms to have an "agreement, understanding, or arrangement."

(6) Multiple acquisitions. Each acquisition of stock of a corporation acquired pursuant to a plan (or series of related transactions) involving a distribution will be

aggregated with all acquisitions of stock of that corporation acquired pursuant to a plan (or series of related transactions) involving that distribution to determine whether an acquisition described in section 355(e)(2)(A)(ii) occurred. The appropriate presumption and rules for rebuttal will be applied to each acquisition depending on when the acquisition occurred.

(7) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests--(i) Treatment of options--(A) General rule. For purposes of this section, if stock of the distributing or controlled corporation is acquired pursuant to an option, the option will be treated as an agreement on the date of issuance unless the distributing corporation establishes by clear and convincing evidence that, on the later of the date of distribution or date of issuance, the option was not more likely than not to be exercised. The determination of whether an option was more likely than not to be exercised is based on all the facts and circumstances. In applying the previous sentence, the fair market value of stock underlying an option is determined by taking into account control premiums and minority and blockage discounts.

(B) Agreement, understanding, arrangement, or substantial negotiations to issue an option. If there is an agreement, understanding, or arrangement to issue an option before the end of the 6-month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement. If an agreement, understanding, or arrangement to issue an option is reached, or an option is issued, more than 6 months but not more than 2 years after the distribution, and there were substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6-month period beginning on the date of the distribution, the option will be treated as issued 6 months after the distribution. If there is an agreement, understanding, or an arrangement to issue an option more than 6 months but not more than 2 years after the distribution, and there were no substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement.

(ii) Instruments treated as options. For purposes of this paragraph (a)(7), except to the extent provided in paragraph (a)(7)(iii) of this section, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), restricted stock, any other instruments that provide for the right or possibility to issue, redeem, or transfer stock (including an option on an option), cash settlement options, or any other similar interests are treated as options.

(iii) Instruments generally not treated as options. For purposes of this paragraph (a)(7), the following are not treated as options unless issued, transferred (directly or indirectly), or listed with a principal purpose of avoiding the application of section 355(e) or this section:

(A) Escrow, pledge, or other security agreements. An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(B) Compensatory options. An option to acquire stock in the distributing or controlled corporation with customary terms and conditions provided to an employee or director in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) and that immediately after the distribution and within 6 months thereafter–

(1) Is nontransferable within the meaning of §1.83-3(d); and

(2) Does not have a readily ascertainable fair market value as defined in §1.83-7(b).

(C) Options exercisable only upon death, disability, mental incompetency, or retirement. Any option entered into between stockholders of a corporation (or a stockholder and the corporation) that is exercisable only upon the death, disability, or mental incompetency of the stockholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the stockholder's retirement.

(D) Rights of first refusal. A bona fide right of first refusal regarding the corporation's stock with customary terms, entered into between stockholders of a corporation (or between the corporation and a stockholder).

(E) Other enumerated instruments. Any other instruments specified in regulations, a revenue ruling, or a revenue procedure. See §601.601(d)(2) of this chapter.

(8) Examples. The following examples illustrate this paragraph (a). Throughout these examples, assume that the distributing corporation (D) owns all of the stock of the controlled corporation (C). Assume further that D distributes the stock of C in a distribution to which section 355 applies and to which section 355(d) does not apply. For purposes of these examples, unless otherwise stated, assume that all transactions described are respected under applicable general tax principles. No inference should be drawn from any example concerning whether any requirements of section 355 other than those of section 355(e) are satisfied. The examples are as follows:

Example 1. To facilitate a stock offering by D of 50 percent of its stock, D distributes C pro rata to its shareholders. D issues new shares amounting to 50 percent of its stock to the public in a public offering within 6 months of the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because the acquisition occurred within 6 months after the distribution, D must rely on the rules of paragraph (a)(2)(iii) of this section to rebut the presumption. D will not be able to rebut the presumption because D cannot establish either that D did not intend that one or more persons would acquire a 50-percent or greater interest in D during the relevant period under paragraph (a)(2)(iii)(A)(1) of this section or that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D under paragraph (a)(2)(iii)(A)(2) of this section. Because the presumption of paragraph (a)(2)(i) of this section cannot be rebutted regarding the acquisition of a 50-percent or greater interest in D, section 355(e) applies to the distribution of C.

Example 2. (i) X corporation announces an intention to acquire D, principally to acquire C's business. Due to market conditions, X's available capital, and X's success in acquiring other corporations, D would reasonably anticipate that an acquisition of a 50-percent or greater interest in D is more likely than not to occur within 2 years. To lower its financing costs and, in substantial part, to deter the acquisition of D (by separating it from the more attractive C), D distributes C pro rata to the D shareholders. X acquires C within 6 months of the distribution.

(ii) Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because the acquisition occurred within 6 months after the distribution, D must rely on the rules of paragraph (a)(2)(iii) of this section to rebut the presumption. Under paragraph (a)(2)(iii)(A)(2) of this section, D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D or C. Under paragraph (a)(2)(iv)(B) of this section, for purposes of paragraph (a)(2)(iii)(B) of this section, persons who more likely than not would have acquired interests in D if the distribution had not occurred are also treated as persons who more likely than not would have acquired proportionate interests in C if the distribution had not occurred. Therefore, under paragraph (a)(2)(iii)(B) of this section, D will be able to establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within 2 years after the distribution who would not have acquired such interests if the distribution had not occurred.

(iii) Under paragraph (a)(2)(iii)(C) of this section, D will not be able to establish that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of D's business by separating it from the C business that was likely to be acquired. Because the presumption of paragraph (a)(2)(i) of this section cannot be rebutted regarding the acquisition by X of a 50-percent or greater interest in C, section 355(e) applies to the distribution of C.

Example 3. The facts are the same as Example 2 except the acquisition takes place 1 year after the distribution. The parties had not reached an agreement, understanding, or arrangement concerning, and had not substantially negotiated, the acquisition of C stock within 6 months after the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Under paragraph (a)(2)(ii)(B) of this section, D's intent to deter an acquisition of D is a factor tending to disprove that the distribution was motivated in substantial part by the desire to lower its financing costs. If D can establish by clear and convincing evidence that the distribution was nonetheless motivated in substantial part by the need to lower its financing costs, D can rebut the presumption using paragraph (a)(2)(ii) of this section. D will not be able to rebut the presumption by using the alternative rebuttal under paragraph (a)(2)(iii) of this section for the same reason as in Example 2.

Example 4. D is a widely held, publicly traded corporation. D distributes C pro rata to D's shareholders. By contract, C agrees to indemnify D for any imposition of tax under section 355(e). The distribution is motivated solely by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired). At the time of the distribution, although D has not been approached by any potential acquirors of C, D would reasonably anticipate that, under current market conditions, if C is separated from D, an acquisition of a 50-percent or greater interest in C is more likely than not to occur within 2 years by persons who would not have acquired a proportionate interest in D if the distribution of C had not occurred. C is acquired within 6 months after the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because the acquisition occurred within 6 months after the distribution, D must rely on the rules of paragraph (a)(2)(iii) of this section to rebut the presumption. D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D or C under paragraph (a)(2)(iii)(A)(2) of this section. However, D will not be able to establish the requirements of paragraph (a)(2)(iii)(B) of this section. Under paragraph (a)(2)(iv)(B) of this section, for purposes of paragraph (a)(2)(iii)(B) of this section, only persons who more likely than not would have acquired interests in D if the distribution had not occurred are treated as persons who more likely than not would have acquired proportionate interests in C if the distribution had not occurred. Therefore, under paragraph (a)(2)(iii)(B) of this section, D will not be able to establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within 2 years after the distribution who would not have acquired such interests if the distribution had not occurred. Under paragraph (a)(2)(iv)(D) of this section, the consequences of the indemnity agreement are disregarded for purposes of applying paragraph (a)(2)(iii)(B) of this section. Because the presumption of paragraph (a)(2)(i) of this section cannot be rebutted regarding the acquisition of a 50-percent or greater interest in C, section 355(e) applies to the distribution of C.

Example 5. (i) D believes it would be a more attractive acquisition candidate if it did not own C. To achieve significant nontax cost savings and, in substantial part, to maximize the possibility of D's acquisition, D distributes C pro rata. At the time of the distribution, D has not, directly or indirectly, solicited or received any indication of interest from potential acquirors. At the end of 6 months after the distribution, no agreement, arrangement, understanding, or substantial negotiations regarding the acquisition of D have taken place. Seven months after the distribution, D engages an investment banker to conduct an auction of D. One of the bidders acquires D 1 year after the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter, D can use the rebuttal under paragraph (a)(2)(ii) of this section if D can establish that the distribution was motivated in whole or substantial part by the corporate business purpose of achieving significant nontax cost savings. Under paragraph (a)(2)(ii)(B) of this section, D's intent to facilitate an acquisition of D is a factor tending to disprove that the distribution was motivated in substantial part by the desire to achieve nontax cost savings. If D can establish by clear and convincing evidence that the distribution was nonetheless motivated in substantial part by the need to achieve nontax cost savings for D and C, D can rebut the presumption using paragraph (a)(2)(ii) of this section.

(ii) D cannot rebut the presumption using the rules of paragraph (a)(2)(iii) of this section because D cannot establish either that D did not intend that one or more persons would acquire a 50-percent or greater interest in D during the relevant period under paragraph (a)(2)(iii)(A)(1) of this section or that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D under paragraph (a)(2)(iii)(A)(2) of this section.

Example 6. D announces that it will distribute C pro rata to D's shareholders. The distribution is motivated solely by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired). After the announcement but before the distribution, D acquires X, a widely held corporation. The X shareholders receive D stock in exchange for their X stock. No person who acquired D stock in the X acquisition became a controlling shareholder of D, as defined in paragraph (a)(4) of this section, within the time period described in paragraph (a)(2)(v)(B) of this section. Under paragraph (a)(2)(i) of this section, the distribution and the acquisition of D stock by the X shareholders are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. If D can establish by clear and convincing evidence that the distribution of C would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition of X, D may rebut the presumption under paragraph (a)(2)(v)(B) of this section.

Example 7. (i) D engages in business 1. C engages in business 2. D is interested in expanding business 1 through acquisitions, but D's ownership of C has been an impediment to acquisitions using D stock. On the advice of its investment banker, D plans to distribute its C stock to its shareholders solely to facilitate acquisitions by D. D has no specific goals regarding how much D stock will be acquired after the distribution. D and its investment banker have identified X and Y as potential acquisition targets. After D decides to distribute its C stock, but before the distribution date, D negotiates with and acquires X, but has no contact with Y. A, X's sole shareholder, receives 30 percent of D's stock, becoming a controlling shareholder of D within the meaning of paragraph (a)(4) of this section. One year after the distribution, D acquires Y. Y's shareholders receive 19 percent of D's stock. After the distribution, D and its investment banker identify Z as another desirable target. Eighteen months after the distribution, D acquires Z. Z's shareholders receive 17 percent of D's stock.

(ii) Under paragraph (a)(2)(i) of this section, the distribution and each acquisition are presumed to be part of a plan (or series of related transactions) because each acquisition occurred within 2 years of the distribution. In addition, under paragraph (a)(6) of this section, all acquisitions for which the presumption is not rebutted are aggregated to determine whether an acquisition described in section 355(e)(2)(A)(ii) has occurred.

(iii) Regarding the acquisition of X, D will not be able to rebut the presumption under paragraph (a)(2)(v)(A) of this section because D cannot establish that at the time A acquired D stock, D did not intend to effectuate a distribution. In addition, D cannot rebut the presumption under paragraph (a)(2)(v)(B) of this section because that paragraph does not apply to an acquisition in which a person becomes a controlling shareholder.

(iv) Regarding the acquisitions of Y and Z, D will not be able to rebut the presumption under paragraph (a)(2)(ii)(A) of this section because D cannot establish that the distribution was motivated in whole or substantial part by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired).

(v) To rebut the presumption with regard to each acquisition of Y and Z using the alternative rebuttal of paragraph (a)(2)(iii) of this section, D must establish three facts. First, under paragraph (a)(2)(iii)(A)(1) of this section, D must establish that, at the time of the distribution, D and its controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest in D or C during the presumption period described in that paragraph. For that purpose, the interests intended to be acquired in D or C will include A's acquisition of D stock under paragraph (a)(2)(iv)(A) of this section. Second, under paragraph (a)(2)(iii)(B) of this section, D must establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within 2 years after the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests if the distribution had not occurred. Under paragraph (a)(2)(iv)(C) of this section, D, C, and their controlling shareholders must treat the amount of D stock acquired by A as an amount they would reasonably have anticipated was more likely than not to be acquired within 2 years after the distribution that would not have been acquired if the distribution had not occurred. Third, under paragraph (a)(2)(iii)(C) of this section, D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

Example 8. D plans to distribute C pro rata to its shareholders. The distribution is substantially motivated by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired). After the announcement date, D's investment banker informs D's management that there is a lot of interest in new investment in D now that it will no longer own C. At the time of the distribution, D would reasonably anticipate that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D within 2 years (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not acquire such interests absent the distribution. Three months after the distribution, D issues an option to X to purchase 50 percent of the D stock. At the time of issuance, the facts and circumstances indicate that the option is more likely than not to be exercised. Two years after issuance, X exercises the option and purchases 50 percent of the D stock. Under paragraph (a)(7)(i)(A) of this section, the option is treated as an agreement on the date it is issued. Under paragraph (a)(3)(i)(A) of this section, the distribution and the acquisition are presumed to be part of a plan (or series of related transactions) because there was an agreement concerning the acquisition within 2 years of the distribution. D will not be able to rebut the presumption using the rebuttals of paragraphs (a)(2)(ii) or (a)(2)(iii) of this section. The rebuttal of paragraph (a)(2)(ii) of this section is unavailable because there was an agreement concerning the acquisition within 6 months of the distribution. The rebuttal of paragraph (a)(2)(iii) of this section is unavailable because D cannot establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D within 2 years (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests absent the distribution. Because the presumption relating to the acquisition of a 50-percent interest in D cannot be rebutted, section 355(e) applies to the distribution of C.

Example 9. (i) D distributes C pro rata to its shareholders solely to facilitate a stock offering by C. To take advantage of favorable market conditions, C issues new shares amounting to 20 percent of its stock in a public offering followed 1 month later by the distribution. The public offering documents disclosed the intended distribution of C. Neither D, C, nor their controlling shareholders intended any further transactions involving D or C stock. In addition, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably anticipate that it was more likely than not that one or more persons would acquire a 50-percent interest in D or C within 2 years (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests absent the distribution. Two months after the distribution, C is approached unexpectedly regarding an opportunity to acquire X. Five months after the distribution, C acquires X in exchange for 40 percent of the C stock. Under paragraph (a)(2)(i) of this section, the distribution and each acquisition are presumed to be part of a plan (or series of related transactions) because each acquisition occurred within 2 years of the distribution.

(ii) Regarding the public offering, D cannot rebut the presumption using paragraph (a)(2)(v) of this section. At the time of the acquisition, D and its controlling shareholders intended to effectuate the distribution. Also, the distribution would not have occurred at approximately the same time and under substantially the same terms regardless of the public offering.

(iii) Regarding C's acquisition of X, D will not be able to rebut the presumption using paragraph (a)(2)(ii) of this section because the acquisition occurred within 6 months after the distribution. However, D will be able to rebut the presumption regarding the acquisition of X using paragraph (a)(2)(iii) of this section. Neither D, C, nor their controlling shareholders intended that one or more persons would acquire a 50-percent or greater interest in D or C during the relevant period under paragraph (a)(2)(iii)(A)(1) of this section. Under paragraph (a)(2)(iii)(B) of this section, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in C within 2 years who would not have acquired such interests if the distribution had not occurred. Under paragraph (a)(2)(iii)(C) of this section, the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired. Because only the 20-percent acquisition by public offering is part of a plan (or series of related transactions) involving the distribution, section 355(e) does not apply.

(b) Multiple controlled corporations. Only the stock or securities of a controlled corporation in which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest as part of a plan (or series of related transactions) involving the distribution of that corporation will be treated as not qualified property under section 355(e)(1) if–

(1) The stock or securities of more than one controlled corporation are distributed in distributions to which section 355 applies; and

(2) One or more persons do not acquire, directly or indirectly, stock representing a 50-percent or greater interest in the distributing corporation pursuant to a plan (or series of related transactions) involving any of those distributions.

(c) Valuation. Except as provided in paragraph (a)(7)(i)(A) of this section, for purposes of section 355(e) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(d) Effective date. The regulations in this section apply to distributions occurring after the regulations in this section are published as final regulations in the **Federal Register**.

Deputy Commissioner of Internal Revenue